Table 4: Factors Influencing Changes in Financial Risk

Factors (in rank order of assigned importance)	Assigned Rank by Companies Perceiving		
	Increase	Decrease	No Change
High interest rates	1	2	1
Drying up of bond markets	4	1	2
Fluctuating interest rates	3	6	3
Weak growth in internal cash flow	2	4	4
Excessive debt	7	3	7
Inferior financial ratios	5	5	9
Inadequate bond interest coverage	6	—[a]	6
Weak borrowing position	11	9	8
Other[b]	8	—[a]	12
Takeover problems	10	7	11
Liquidity problems	12	8	5
Financial reporting problems	9	—[a]	10

[a]The eight companies perceiving reduced financial risk did not mention this factor as contributing to a change in financial risk.
[b]Responses include uncertainty of inflation, size of budget and cash flow, and poor operating results.

objectives. Second, they strive to meet rating-agency requirements so as to maintain credit ratings on bonds, commercial paper, and trade credit relationships. Third, they attempt to demonstrate to lenders and investors that internal management controls are operating in a manner that permits realization of financial targets and maintenance of overall debt quality.

Considerations that enter into the picture with respect to how corporations attempt to realize these goals include the following:

(1) Control of financial risk is one aspect of a broad system of financial planning and control. These other aspects include strategic planning, budgeting and forecasting, working capital management, capital budgeting, and control over borrowing and funds sources. Development of an integrated system of financial planning and control requires that detailed consideration be given to control over financial risk.

(2) Analysis and control of financial risk provides the corporation with an important ingredient in its control over all other types of risk (including credit risk, business risk, and foreign investment risk).

(3) Effective control over financial risk widens the range of potential sources of funds available to borrowers.

(4) Effective control over financial risk results in a higher market valuation of a corporation's securities. A by-product of this is that the corporation tends to gain greater protection against unexpected takeover bids.

Financial management practices can have a significant influence on these goals and considerations. The 50 responding companies in the Board's survey were asked to indicate the measures they found most important in controlling financial risk. Also, they were requested to rate the importance of various measures they have adopted in maintaining credit ratings. In addition, they were asked to state whether financial market conditions or company internal measures are more important in maintaining or improving debt ratings. Finally, they were requested to report any significant recent changes in bond-indenture provisions.

The 50 companies follow a number of policies and practices designed to limit or minimize financial risk. The relative importance of these measures is indicated by the rankings in Table 5. The ten types of measures employed fall into four distinct categories: measures to control

Table 5: Measures Used by Companies to Minimize Financial Risk

Policies and Practices (in Order of Importance)	Goals			
	Control Debt	Control Interest Expense	Efficient Asset Use	Profit and Cash Flow
Increase efficiency of asset management and increase cash flow			X	X
Maintain conservative debt ratio	X			
Improve financial forecasting and budgeting for better use of funds			X	
Establish minimum standard for interest and overall debt-service coverage		X		
Establish minimum liquidity standards			X	
Establish monetary limit on total debt	X			
Establish monetary limit on short-term debt	X			
Refund debt at lower interest rate when possible	X	X		
Other (improve company profit margins)				X
Establish a monetary limit on total interest expense		X		

debt, measures to control interest expense, measures to increase the efficiency of asset use, and measures to improve profit and cash flow.

These rankings focus primarily on what corporate management is able to implement. In addition, companies were asked to comment on the attitudes of credit-rating agencies concerning measures that are important in maintaining or improving company debt ratings.

Survey cooperators believed that maintaining or improving profitability is first in importance in the eyes of credit-rating agencies. The reasons are that high profitability reduces the need for extensive debt financing during periods of high asset growth, provides cash flows needed for debt service, and permits stockholders' equity to grow in relation to debt. Ranked second in importance is the maintenance of adequate debt-service coverage. The companies ranked the maintenance of a satisfactory stockholders' equity cushion in relation to debt third in importance. The other three measures among the first six were: maintaining adequate liquidity; maintaining bank credit lines; and successfully bringing new investment on-stream.

On an overall basis, the 50 responding companies assigned high importance to internal measures in maintaining or improving company debt ratings. Finally, they indicated that bond-indenture provisions have changed very little in recent years to give more protection to investors.

When asked to comment on the effects of off-balance-sheet financing (e.g., leasing) on company credit or debt ratings, most respondents (27) reported that there are no noticeable effects; 13 reported they have not used off-balance-sheet financing. The other ten respondents volunteered reasons for not using this method of financing.

Typical comments pertaining to off-balance-sheet financing are:

"Financial institutions incorporate these effects in their overall analysis."

—Treasurer of a retail food chain

* * * *

"Our capital asset requirements do not lend themselves to extensive or leveraged leasing."

—Treasurer of an electrical and consumer products manufacturer

* * * *

"Even under the new tax and leasing laws, we should probably continue to buy assets, not lease them."

—Financial manager of a diversified manufacturer of durable products.

The Outlook for Financial Risk

The surveyed companies were asked to indicate whether they expect any changes in financial risk exposure over the period 1982 to 1985. Of those responding:

- 15 expect an increase in financial risk;
- 14 expect a decrease;
- 14 expect no change.

Table 6 provides a comparison of company perceptions concerning financial risk for the two periods 1979 to 1981 and 1982 to 1985. Of the 43 companies reporting for both periods, 12 had the same perceptions of changes in financial risk: Seven expected financial risk to increase in both periods; five companies expected no change in risk in both periods.

Seven companies that had perceived increased risk for the earlier period expect this trend to continue (Table 6). Their comments ranged from concern over the need to borrow to finance capital expenditures to expectations that the economic environment will remain difficult. The comments of two large-size durable goods producers are typical:

"We expect a difficult economic environment and, therefore, pressure on earnings and continued high interest rates."

"Large capital expenditures for the next five years will require some borrowing."

Similarly, a large manufacturer of nondurable goods noted:

"Unless we improve on profit margins, we will not be able to finance the growth in our business from internal sources (excluding sale of assets)."

Comments made by the five companies perceiving no change in financial risk in both periods assumed a

Table 6: Changing Perceptions of Financial Risk

Company Perceptions Covering Period	*Company Expectations for Period 1982 to 1985*			
1979 to 1981	*Increase*	*Decrease*	*No Change*	*Total*
Perceive Increased Financial Risk (27 Companies)	7	13	6	26
Perceive Decreased Financial Risk (8 Companies)	2	0	3	5
Perceive No Change in Financial Risk (14 Companies)	6	1	5	12
Total	15	14	14	43

favorable turn in the economy. The following comment by a construction materials manufacturer is illustrative:

"We expect business conditions to improve, resulting in a sufficient improvement in earnings and cash flow to service any debt created."

An aerospace manufacturer commented:

"Although we may have to pay more for our borrowed money in the years ahead, this increased expense will not have a tremendous impact on our bottom line since we are not heavily leveraged. Thus, our credit rating should remain strong, and we should be relatively immune from the problems of a credit crunch—should one come."

As against the 12 companies that held to the same perceptions concerning exposure to financial risk in both periods, 31 companies expected changes. The largest shift in attitude is among a group of 13 companies that perceived increased financial risk in 1979 to 1981 but predicted decreased financial risk in 1982 to 1985. These 13 companies cover all size and industry categories. Among nondurable goods manufacturers, the explanations for reduced financial risk in the near future include better control over investment and working capital requirements, and an improvement in the economy that will lead to increased earnings and cash inflows. Among durable goods manufacturers, explanations for reduced financial risk include improved financial ratios and improved internal cash generation. One manufacturer of construction and agricultural equipment noted:

"We anticipate improved demand in the markets which we serve, which will result in improved income for the company. Also, we believe interest rates will decline from their 1981 peaks to more realistic levels, although not to historical lows. The 8-percent, 25-year debenture is a thing of the past."

Thirteen companies that perceived increased financial risk in 1979 to 1981 expect reduced financial risk in the future. Six companies that perceived increased financial risk in the earlier period expect no change in financial risk in the future. Ranging in industry categories from steel, housewares and instruments to industrial plant monitoring equipment, these companies offer various explanations for expecting no change in financial risk in the future. One of the smaller sized companies in this group of six noted:

"While expansion will require additional financing, it is anticipated that improved economic conditions will enable our company to finance its needs via improved cash flow."

None of the companies that perceived decreased financial risk in 1979 to 1981 expect decreased financial risk in 1982 to 1985. Two of these expect increased financial risk in the future period. One of these companies offered the explanation that there will be "increased use of debt because of internal expansion and possible acquisition activities." Three companies that perceived decreased financial risk in the last three years expected no change in the next four years. A nonmanufacturing firm attributed this opinion to an improvement in fixed-charge coverage. A capital goods manufacturer explained that its financial needs should be satisfied with internal funds and that the debt/equity ratio should improve.

Six of the companies that perceived no change in financial risk in 1979 to 1981 expect an increase in financial risk in 1982 to 1985. This group includes companies producing electrical products, pharmaceuticals, capital equipment, housewares and industrial products. Explanations offered for the expected increase in financial risk included possible acquisitions, and the need to borrow large amounts due to inflation and expanding markets. According to a large durable goods manufacturer:

"The bond market has almost disappeared. We have heavy maturities coming due on existing long-term debt."

Finally, one company that reported no change in financial risk in 1979 to 1981 expected a reduction in financial risk in 1982 to 1985. This information-oriented firm that engages in nondurable goods manufacturing noted:

"We expect a significant improvement in our working capital and liquidity position. This will be generated from internal funds."

* * * * *

To sum up: Many companies are concerned with financial risk and its implications for their day-to-day financial activities. A majority of the companies surveyed perceive that financial risk has already increased, or will do so in the future. Some companies that report no increase or a reduction in financial risk are able to do so because of austerity or other financial management policies implemented in the recent past. Companies concerned with increased financial risk also have taken measures to strengthen their financial position. These include measures to control debt, to improve profit and cash flow, to improve on efficient use of assets, and to control interest expense.